



ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES  
INVESTMENT INDUSTRY ASSOCIATION OF CANADA

**Jack Rando**  
**Director, Capital Markets**

July 10, 2008

Mr. Gérard Lalonde  
Director, Tax Legislation Division  
Tax Policy Branch  
Department of Finance Canada  
140 O'Connor St., 17<sup>th</sup> Floor, East Tower  
Ottawa, Ontario K1A 0G5

Dear Mr. Lalonde:

**Re: Broker Warrants under Proposals Related to the Taxation of Financial Institutions**

We are writing to request discussion of an exemption for broker warrants from a “tracking property” under the definition of mark-to-market property, which is part of changes proposed to the *Income Tax Act and Regulations* in *Legislative Proposals and Explanatory Notes Related to the Taxation of Financial Institutions*, published on November 7, 2007. We agree that, in the general course, requiring unexercised warrants to be valued and unrealized profits on these warrants to be recognized as income and taxed is appropriate tax policy, but believe that this will inadvertently have a lose-lose-lose result in the case of broker warrants which are different from traditional warrants and which we believe may have been unknown to the legislative drafters:

- Issuers of broker warrants, tend to be junior issuers – often small resource firms looking for mineral, metal or energy deposits; and research/innovation firms; etc. Taxing the broker warrants as proposed will likely reduce underwriter interest in such issuers as the net return equation will decrease due to the need to pay tax earlier than currently. The support of the underwriters is critical to junior issuers that have fewer financing options in respect of their capital raising activities, which are often essential for their survival. In addition backing by an underwriter encourages a more active following of the issuers’ stock and market-making.
- The intermediaries that will be affected will in almost all cases be small or mid sized brokers that deal in the junior market and accept broker warrants as sweeteners – larger firms do not typically cater to this market.

The net impact will be reduced growth potential for small and medium-sized companies seeking to raise capital, particularly those listed on public markets. This is contrary not only to the interests of these issuers, their investors and the intermediaries, but also to the Canadian economy, which relies on such businesses to generate economic activity and growth. There are also practical problems for the intermediaries as the proposed treatment will result in the payment of tax on “unrealized” gains that may never ultimately materialize.

## Broker warrants

Broker warrants are little known outside the junior capital market which includes smaller issuers, risk investors and small brokers. We have not yet been able to identify if broker warrants are used outside of Canada. Like traditional warrants, broker warrants generally have a term of 18 months to two years but in contrast to other warrants, the shares related to broker warrants have certain features that it is difficult to accommodate within traditional valuation models. For example, broker warrants:

- Have trading prices (and underlying share prices) that are considerably more volatile than typical warrants and shares
- Are almost always not transferrable
- Have a hold or restricted period imposed where no trading can occur and may not be traded for long periods, even when they are transferable
- May lead to follow-up financings and/or to the underlying security being suspended, both of which events may prevent all or a portion of the broker warrant position, from being exercised at certain times or ever
- May result in operational challenges should the broker decide to sell broker warrants when they are in the money. It can take up to two weeks to receive the shares upon exercising a position by which time the profit opportunity can be lost.
- May not be able to be sold back into the market if they are in the money, as many of the issuers that use broker warrants do not have significant liquidity and the attempted sale of these securities may have a negative effect on the value of the issuer's securities.

Taxing unrealized gains may also lead to behaviour driven by tax, rather than business considerations. Firms may be compelled to exercise the warrants sooner than desirable to lock in any gain rather than pay taxes on an apparent gain that may not exist when the warrant is exercised. This will put greater downward pressure on prices of the related stocks, which is in neither the issuer's, the investor's nor the public's best interest.

From an operational perspective, applying market prices to broker warrant positions is largely a manual and extremely time-intensive process. This is already particularly problematic for the smaller dealers serving junior issuers, as these dealers are less likely to have the technology to automate the process to the extent this is possible. Moreover, applying traditional models to calculate fair value leads to significant volatility of earnings in many cases, which is inconsistent with the accounting principle of conservatism and the use of management's best judgment. Moreover recent events in capital markets have demonstrated only too well the drawbacks of valuation tools that rely on assumptions which can prove to be wrong.

We would welcome the opportunity to meet with you and hope to meet with others within the government who we believe may share our members' concerns. We would be pleased to arrange a meeting or teleconference with a small number of market participants to demonstrate the problems we see with the proposed rules and answer questions that you may have. We will follow up shortly to discuss this matter further.

Yours sincerely,

